MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

08 July 2021

Transposition and Implementation of the CRDV Package

The New EU Banking Package: CRRII & CRDV

The aim of this Circular is to provide credit institutions with an overview of the main changes that were brought about by the CRDV Package and provide guidance on the supervisory expectations. Moreover, this Circular will provide an update on the status of the transposition process of the CRDV into national legislation.

Introduction

The CRDV Package was adopted by the European Parliament and the Council on 20 May 2019 and consists of a Regulation (i.e. the CRRII), and a Directive (i.e. CRDV). It continues to build on the existing CRDIV and CRR legislative package, which establishes the prudential framework for credit institutions authorised or licensed in the EU. The overall aim of the package is to strengthen the resilience of the EU banking sector so it would be better placed to absorb economic shocks while ensuring that credit institutions continue to finance economic activity and growth. The Authority has been working on the transposition of the CRDV into national legislation which is now in the final stages. The relevant Bill amending various financial services legislation, including the Banking Act, will shortly be tabled in Parliament and are expected to be published in the coming months. The publication of the relevant amendments to the subsidiary legislation and to Banking Rules that are issued under the Banking Act (Chap. 371 of the Laws of Malta) will then follow in order to transpose the remaining CRDV provisions.

In view of the above, the Board of Directors should ensure that their banks are compliant with the CRDV requirements.

Main changes of the CRDV Package

By way of an overview, the following are the main changes that the CRDV Package has brought about:

<u>Leverage Ratio</u>

The CRR introduces a non-risk-based ratio (binding requirement) whereby credit institutions are required to maintain a minimum of leverage ratio of 3%. The aim of this ratio is to restrict the build-up of excessive leverage. The leverage ratio is expressed as the credit institution's Tier 1 capital in proportion to the total exposure taking into consideration both on- and off-balance sheet exposures as a proportion to capital. In case of a breach of the leverage ratio requirement, certain restrictions may apply, including restrictions on distributions.

Credit institutions are therefore required, amongst others to have systems in place to monitor their leverage ratio; inform the Authority where the 3% leverage ratio is breached; consider aspects such as the extent of effect on the credit institution; and have clear visibility on how the credit institution will be meeting this requirement.

Standardised Approach to Counterparty Credit Risk (SA-CCR)

The CRDV framework introduced a new standardised approach, the so-called Standardised Approach for Counterparty Credit Risk (SA-CCR), which is a more risk-sensitive measure of counterparty risk. A simplified version of the SA-CCR has been introduced for credit institutions that meet predefined eligibility criteria and for credit institutions that form part of a group which meets those criteria on a consolidated basis. Where the SA-CCR and even the simplified SA-CCR prove too complex to implement, subject to certain conditions, credit institutions with limited derivative exposures can use an adjusted Original Exposure Method (OEM) as an alternative approach.

In view of this credit institutions are required, amongst others, to identify to what extent the credit institution's capital buffer is released; consider how it will be using the capital and whether it would be investing it in risky positions.

Large Exposures Framework

One of the key changes under the new prudential framework is that the 25% exposure limit will be calculated on the capital base of the Tier 1 capital instead of eligible capital. This will result in more stringent limits in order to further mitigate the concentration risk that credit institutions are exposed to. Thus, higher quality of capital, i.e. only Tier 1 capital, shall be used as a capital base for the calculation of the large exposures limit.

Credit institutions are required to report to the Authority exposures, including the 20 largest exposures, exposures larger than or equal to EUR 300 million but less than 10% of Tier 1 capital and the top ten exposures to "shadow banks"; inform the Authority if they are in breach of the Large Exposures regime and submit a plan for timely return to compliance. Boards should ensure these requirements are integrated into their reporting frameworks and ICAAPs.

Net Stable Funding Ratio (NSFR)

The NSFR is a new requirement whereby credit institutions are bound to maintain an NSFR of 100% or above. This will indicate that a credit institution holds sufficient stable funding to meet its funding needs over a one-year horizon under both normal and stressed conditions. In line with the proportionality principle, the new requirements provide the option for small and non-complex credit institutions to use a simplified version of the NSFR requirement. Nevertheless, this is subject to the Authority's prior approval. A simplified version would reduce the complexity of the calculation for those credit institutions which fall within scope.

Boards should ensure their systems are configured to report the NSFR in line with CRDV requirements.

Revisions to SA and IRB Approach for Credit Risk

The following factors which allow preferential treatment have been included in the CRR2:

- SME supporting factor (small and medium-sized enterprises (SMEs)): Since SMEs carry a lower systematic risk than larger corporates, capital requirements for SME exposures should be lower in order to ensure an optimal bank financing of SMEs. The following changes have been made in this respect:
    - 23.81% reduction in the risk weighted exposure amount for SMEs is extended to SME exposures of up to EUR 2.5 million (an increase from EUR 1.5 million); and
    - the part of an SME exposure exceeding EUR 2.5 million will be subject to a 15% reduction in capital requirements. Thus, more SME exposures will be benefit from such reduction.
    -

- <u>Infrastructure supporting factor:</u> Own funds requirements for exposures to private and public investments in infrastructure projects that provide or support essential public services will be reduced. This is applicable to certain 'corporates' and 'specialised lending'. Exposures falling within the scope of the infrastructure supporting factor a supporting factor of 0.75 can be applied.

Credit institutions are required to assess the impact that this would have on their business plans and incorporate the revised risk weighting factors in their reporting and ICAAP. Where it is relevant, they should set out how they will be using any freed-up capital.

<u>(Mixed) Financial Holding Companies</u>

The CRDV framework introduces a new approval requirement for holding companies which fall within the definitions of FHC and MFHC set out in the CRR. This specific approval procedure together with direct supervisory powers granted to the competent authorities over certain (M)FHC will ensure that such holding companies can be held directly responsible for ensuring compliance with consolidated prudential requirements. Furthermore, the CRDV provides for the exemption from the approval of those holding companies which are set up for the purpose of holding participations in undertakings.

FHCs and MFHCs which have a credit institution as a subsidiary and fulfil the conditions stipulated in the CRDV are required therefore to seek the approval or the exemption from approval of the consolidating supervisor, or the competent authority, as applicable; ensure compliance with the conditions for approval or exemption on an ongoing basis; and adhere to any supervisory measure that may be imposed by the competent authority or the consolidating supervisor.

Boards should assess whether they need to make an application for approval or exemption from approval in respect of a holding company in their group and notify their supervisory contact of their assessment.

<u>Pillar 2 Capital</u>

The CRDV clarifies a number of requirements relating to the Supervisory Review and Evaluation Process (SREP) as well as the supervisory measures based on such process. Banks are required to meet their applicable Pillar 2 requirement (P2R) and are expected to hold Pillar 2 Guidance (P2G) in order to align capital requirements to risks where a quantitative methodology is not laid down in CRDV so as to ensure that banks hold enough capital to cover losses arising from stress events. The P2R and P2G will be determined and set by the MFSA according to the SREP assessment. In accordance with the CRDV, banks are required to meet their P2R with at least 75% Tier 1 capital, and 75% of such Tier 1 capital must consist of Common Equity Tier 1.

In view of this credit institutions should have adequate and appropriate internal governance arrangements, processes and mechanisms in place; and have controls in place with respect to each risk.

<u>Anti-money laundering (AML)</u>

The CRDV package strengthens the AML dimension in authorisation, fit and proper assessments and SREP. Pursuant to the CRDV, the Authority may remove directors of credit institutions if, inter alia, it suspects, that money laundering or terrorist financing has been committed or attempted. Furthermore, competent authorities shall consistently factor money laundering and terrorist financing concerns in their supervisory activities, including SREP, assessments of adequacy of governance arrangements, processes and mechanisms, and assessments of suitability of directors.

Way Forward and Contact Points

The Authority will be informing the industry through upcoming Circulars once the relevant local legislation has been published. Should you have any queries in relation to the above, please do not hesitate to contact your supervisory contact at the MFSA.

Disclaimer: The content of this Circular shall only be considered for information purposes. It should not be construed as advice and should not be treated as such. Credit institutions shall refer to the applicable legislation and shall carry out their own assessments in order to ensure compliance with the applicable regulatory requirements.

Triq l-Imdina, Zone 1 Central Business District, Birkirkara CBD 1010
+356 2144 1155
communications@mfsa.mt
www.mfsa.mt